In the Supreme Court of the United States

OCTOBER TERM, 1927

No. 156

L. M. WILLCUTS, COLLECTOR OF INTERNAL REVENUE for the District of Minnesota, Petitioner

v.

MILTON DAIRY COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF ON BEHALF OF THE PETITIONER

OPINIONS OF THE COURTS BELOW

The District Court rendered an opinion (R. 14) which is reported in 8 F (2d) 178. The opinion of the Circuit Court of Appeals (R. 25) is reported in 15 F. (2d) 814.

JURISDICTION

The judgment of the Circuit Court of Appeals was rendered on September 25, 1926. (R. 28.) Petition for certiorari was filed December 23, 1926, and granted January 24, 1927 (R. 29), pursuant to Section 240, Judicial Code, as amended by the Act of February 13, 1925.

THE QUESTION

In computing the invested capital of a corporation for the fiscal years 1919 and 1920, under Section 326 of the Revenue Act of 1918, should invested capital be increased by the amount of net earnings for the fiscal years 1918 and 1919, where there existed at the beginning of the fiscal year 1918 an operating deficit of $70,296.12, and the net earnings for the years 1918 and 1919 were only $34,397.40, or should such net earnings first be applied to offset an existing operating deficit before there can be any surplus or undivided profits to be added to invested capital?

THE STATUTES

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1092:

> SEC. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivisions (b) and (c) of this section):
>
> (1) Actual cash bona fide paid in for stock or shares;
>
> (2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: *Provided*, That the Commissioner shall keep a record of

all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257;

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at

the beginning of the taxable year, whichever is lowest: *Provided*, That in no case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but

(b) As used in this title the term "invested capital" does not include borrowed capital.

(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year.

(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall (except for the purpose of paragraph (2) of subdivision (a) of section 311) be the same fractional part of such average invested capital.

The average invested capital for the prewar period shall be determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the average invested capital for such years.

TREASURY REGULATIONS

Regulations 45 (1920 Edition), Article 838:

Surplus and undivided profits; earned surplus.—Only true earned surplus and un-

divided profits can be included in the computation of invested capital, and if for any reason the books do not properly reflect the true surplus such adjustments must be made as are necessary in order to arrive at the correct amount. In the computation of earned surplus and undivided profits full recognition must first be given to all expenses incurred and losses sustained from the original organization of the corporation down to the taxable year, including among such expenses and losses reasonable allowances for depreciation, obsolescence or depletion of property (irrespective of the manner in which such property was originally acquired), and for the amortization of any discount on its bonds. There can of course be no earned surplus or undivided profits until any deficit or impairment of paid-in capital due to depletion, depreciation, expense, losses or any other cause has been made good. Where adequate evidence is presented that the amounts written off or deducted in previous returns of net income are in the aggregate incorrect or unreasonable, adjustments must be made, and the taxpayer will be allowed a refund in respect of any taxes overpaid in prior years, or in the case of an underpayment of taxes will be additionally assessed.

Regulations 45 (1920 Edition), Article 860:

Impairment of Capital.—Capital or surplus actually paid in is not required to be reduced because of an impairment of capital in the nature of an operating deficit, except

where there has been directly or indirectly a liquidation or return of their investment to the stockholders, in which case full effect must be given to any liquidation of the original capital.

STATEMENT

The Milton Dairy Company, hereinafter referred to as the Company, is a Minnesota corporation, and L. M. Willcuts, petitioner, was Collector of Internal Revenue for the District of Minnesota. (R. 12.) The company kept its books on the basis of a fiscal year ending on the last day of February each year. (R. 13.) The company filed a corporation income and profits tax return for the fiscal year ending February 28, 1919, and included in its invested capital the sum of $11,489.26, alleged to be profits for the fiscal year 1918 remaining in the business, and included in its invested capital for the fiscal year ending February 28, 1920, the additional sum of $22,908.14 alleged to be profits for the fiscal year 1919 remaining in the business. (R. 13.) During the fiscal years 1918 and 1919 there had been no distribution of profits to the stockholders of the company. (R. 13.) On February 28, 1917, at the beginning of the fiscal year 1918, the company had an impairment of capital resulting from a previous operating deficit of $70,296.12 (R. 13), which was in excess of the so-called profits for the fiscal years 1918 and 1919.

The Commissioner allowed as invested capital the sum of $145,817.04 (R. 13), which amount

represented capital actually paid in prior to February 28, 1917. The Commissioner excluded from invested capital the sums of $11,489.26 and $22,908.14, the net earnings for 1918 and 1919, on the ground that said sums must first be applied to make good the impairment of capital resulting from the operating deficit before there could be any surplus or undivided profits to be treated as invested capital. Additional taxes were assessed and paid under protest for each of said fiscal years, and claims for refund in the sum of $1,274.30 for the fiscal year 1919, and $529.89 for the fiscal year 1920, were duly filed and rejected, whereupon this suit was instituted. (R. 13.) The District Court rendered a judgment for the Collector, which the Circuit Court of Appeals reversed.

SPECIFICATION OF ERROR TO BE URGED

The court erred in holding that under Section 326 of the Revenue Act of 1918 there is "surplus or undivided profits" which should increase the invested capital of a corporation where its past operations show an actual operating deficit, resulting in an impairment of its capital.

SUMMARY OF ARGUMENT

The words "surplus and undivided profits" used in the statute should be given their ordinary meaning. A corporation has no surplus or undivided profits unless its assets exceed its liabilities (including capital-stock liability).

If such an excess exists, it is often separated into two items on the books, one called "surplus" and the other "undivided profits," but neither can exist without such an excess of assets.

There is nothing in the language or the purpose of this statute to justify taking the words "surplus and undivided profits" in any other than their usual sense.

The fact that under this statute and the regulations that part of the statutory invested capital contributed by the stockholders was not to be reduced by operating losses does not require that net earnings in any year should be added to invested capital, although insufficient to restore impairment of capital resulting from previous operating losses.

The construction of the law uniformly followed by the Treasury Department over a long period of years should not be rejected.

ARGUMENT

UNDER SECTION 326 OF THE REVENUE ACT OF 1918 THERE COULD BE NO ADDITION TO INVESTED CAPITAL BY WAY OF SURPLUS OR UNDIVIDED PROFITS UNLESS NET EARNINGS EXCEEDED AN IMPAIRMENT OF CAPITAL RESULTING FROM PREVIOUS OPERATING DEFICITS

The statute provided that the excess-profits tax should be imposed only on that part of the net income remaining after deducting from net income the amount of a return at a rate fixed by the statute on what is described as "invested capital." It also provided that the "invested capital" should include

"surplus and undivided profits," and the problem here is to determine the meaning of the words "surplus and undivided profits."

According to their ordinary meaning it is plain that a corporation whose assets are less than its liabilities (including capital stock liability) has no surplus or undivided profits, and that a corporation which has had net earnings for two or three years, nevertheless has no surplus or undivided profits if, as the result of operating losses in the past, its capital has been, and still is, impaired. In this respect, there is no difference between "surplus" and "undivided profits." These terms are different labels for the same thing.

It is common practice for corporations, especially banking and financial corporations, to divide their true surplus funds into two items on their books, one called "surplus" and the other "undivided profits." When this is done it is generally understood that the "surplus," although representing assets in excess of liabilities and therefore divisible as dividends, is set apart as a more or less permanent addition to the working capital, while "undivided profits," usually representing recent net earnings, are usually understood to be intended for immediate distribution as dividends or, possibly, to be transferred to the so-called surplus account. In any event "surplus" and "undivided profits" are alike in one respect, in that each represents a part of the amount by which the assets exceed the liabil-

ities (including capital-stock liability), and in that neither surplus nor undivided profits exist if the assets do not exceed the corporation's liabilities (including capital-stock liability).

For a corporate financial statement to attempt to set up either a surplus or an undivided profits account, when its capital is impaired, would be absurd. The term "undivided profits" carries the inference that the profits are divisible as dividends and has never been used in any other sense. Every one with the most elementary knowledge of accounting knows these things to be so.

See—

Leather Manufacturers' National Bank v. *Treat,* 116 Fed. 774.

Insurance Company of North America v. *McCoach,* 218 Fed. 905, 908.

The respondent, Milton Dairy Company, between the date of its organization and February 28, 1917, the beginning of its fiscal year 1918, had suffered losses in operation, resulting in an impairment of its capital in the amount of $70,296.12. Its net earnings for its fiscal years 1918 and 1919 aggregated only $34,397.40. The impairment of capital was not made good.

It is plain that the net earnings of 1918 and 1919 produced neither "surplus" nor "undivided profits," as those terms are ordinarily understood. Unless, therefore, there is some reason for assigning to these words as used in this statute a meaning out of the ordinary, the Commissioner was clearly

right in holding that there were no undivided profits to form an addition to the statutory invested capital.

We are unable to find anything in the terms of the statute or in its purpose which justifies the rejection of the ordinary meaning of these terms.

The underlying principle of the "excess" profits tax was that the taxpayer should be allowed, free of the tax, a reasonable return fixed by the statute on his investment and what had been added to it by accumulation of profits. See *LaBelle Iron Works* v. *United States,* 256 U. S. 377. From the total net income there was to be deducted the amount prescribed by the statute as a reasonable return on what the statute defines as "invested capital" and the remainder of the income was treated as "excess" profits and subjected to the excess profits tax. The "invested capital" so prescribed was not the actual capital in the business during the tax year in question. The statute prescribed what items of the amounts originally invested in the corporation's shares should be included in the invested capital, and provided in subdivision (3) here in question that "paid-in or earned surplus and undivided profits" should be included. Two kinds of surplus were included, that "paid in" and that "earned." The provision in subdivision (3) relating to "paid-in" surplus was probably unnecessary except to cover surplus "paid in" by the stockholders after shares were issued and not

in payment for shares (a most unusual case), because surplus paid in for shares was already included by subdivisions (1) and (2).

The statute and the regulations adopted the equitable view that the deduction from income of a reasonable return on the amounts contributed by the stockholders should be allowed notwithstanding the investment had been lost or impaired by losses in operation, but there was no equitable ground for, and there is nothing in the statute to require, allowing *earned* surplus and undivided profits, not contributed out of the pockets of the stockholders, to become a fixed and permanent part of "invested" capital, not reducible by subsequent operating losses, or, conversely, as claimed by respondent in this case, where the operating losses and impairment of capital occur first, allowing the later net earnings to become a fixed addition to "invested capital," although insufficient to restore the previous operating losses of the capital investment.

The reasoning of the Circuit Court of Appeals and the argument of the respondent both lead to the conclusion that all net earnings in any year became an addition to invested capital, but net losses in any year never operated to reduce such additions to invested capital, with the result that the invested capital might be increased but never reduced as the result of gains or losses in operation. See *Appeal of Gould Coupler Co.*, 5 B. T. A. 499, 517. Such a conception is artificial and arbi-

trary, has no basis in reason, and is not suggested by anything in the statute. There seems to be a difference in this respect between paid in surplus and earned surplus, recognized by Article 860 of the Regulations, and it is quite logical that there should be a difference between additions to invested capital resulting from investments by the stockholders and additions not contributed by them but resulting from operations.

The opinion of the Circuit Court of Appeals offers no satisfactory reason for failing to give to the words "surplus and undivided profits" their usual significance.

It discloses some confusion as to the operation of the statute in speaking of deducting invested capital from income (R. 25) and the "deduction of 'undivided profits' as part of the 'invested capital'" (R. 26), things which do not occur under the statute.

The extract in the opinion of the Circuit Court of Appeals from the opinion of this Court in *Edwards* v. *Douglas,* 269 U. S. 204, gives no support to the decision below. In that case this Court was dealing with the rate of taxation on dividends which depended on the year in which the profits out of which the dividends were paid were accumulated. Clearly, there could be no dividends in the absence of assets in excess of liabilities (including capital stock liability) and everything the Court held or said about earnings in that case related to earnings which had the effect of creating or increasing a sur-

plus or undivided profits properly divisible as dividends, and therefore representing an increase in the assets over and above the amount of liabilities.

The Circuit Court of Appeals rejects the usual formula for ascertaining surplus and undivided profits, which is to determine the amount of assets in excess of liabilities, but we have searched in vain in the opinion for any substitute or any definite statement of the method which is to be used. If the learned Circuit Judge who wrote the opinion had attempted to work out his theory in a concrete way he would have reached an impasse.

The respondent offers no more satisfactory reasoning or formula. The Circuit Court of Appeals treated "surplus" and "undivided profits" alike and held that there could be both surplus and undivided profits as the terms are used in this statute, notwithstanding the corporation's assets were less than its liabilities and its capital was impaired. It thus recognizes our contention that "surplus" and "undivided profits" are merely accounting terms to describe essentially the same thing. The respondent abandons the Circuit Court of Appeals in this. It concedes that there was no "surplus," but still contends that there were "undivided profits." In its brief in opposition to the petition for certiorari it is said (p. 4):

> This respondent has never claimed a surplus, does not now claim a surplus, and has not the hardihood to claim any rights by virtue of a "surplus."

This argument has the additional weakness that it yields the point that the word "surplus" was used in this statute in its ordinary sense and yet insists that the words "undivided profits" in the same sentence are to be given some artificial or unusual meaning. "Net earnings" for a particular period and "undivided profits" are different things, and yet respondent treats them as synonymous. If it used "net earnings" as describing the net earnings for the entire period of the corporation's existence *taken as a whole* we would not complain, because then the result would be "undivided profits" as we understand the term only if aggregate earnings for some years exceeded the aggregate losses in the others, but to say that undivided profits exist because in one or two years of a corporation's existence it has made net earnings which are less than its aggregate net losses during the other years of its existence, is to arbitrarily manufacture new meanings for well understood words.

If anything further need be said it is that the Treasury Department has consistently applied the law as we urge it, and its regulations have for years provided accordingly. The Board of Tax Appeals has sustained it (*Appeal of Valdosta Grocery Co.*, 2 B. T. A. 727), and followed the opinion of the District Court in this case. No adequate reasons are advanced for overturning the established practice of the Bureau of Internal Revenue and rejecting the construction of the

statute it has so long applied. The District Court was right and the judgment of the Circuit Court of Appeals should be reversed.

Respectfully submitted.

WILLIAM D. MITCHELL,
Solicitor General.
MABEL WALKER WILLEBRANDT,
Assistant Attorney General.
A. W. GREGG,
General Counsel, Bureau of Internal Revenue.
J. R. WHEELER,
Special Attorney, Bureau of Internal Revenue.

SEPTEMBER, 1927.

○